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SUBJECT: CHINA EASTERN-SHANGHAI AIRLINES MERGER HIGHLIGHTS
COMPLICATIONS IN CONSOLIDATING STATE SECTOR

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¶1. (U) This cable contains business proprietary information and is Sensitive but Unclassified. Please handle accordingly.

¶2. (SBU) Summary: Central Government-owned China Eastern completed its long awaited merger with local rival Shanghai Airlines on January 29, with substantial concessions to the locally owned competitor. Noting that the Shanghai Airlines brand will be retained for at least another three years, China Eastern representatives claimed that the merger would result in close to 50 percent market share of the lucrative Shanghai market. While officials from both carriers declined to speculate as to which global airline alliance China Eastern would eventually join, a China Eastern representative strongly hinted that the Oneworld Alliance is the likely candidate. End Summary.

Thanks to Expo, China Eastern Optimistic about 2010 prospects

¶3. (SBU) China Eastern's (CEA) merger with Shanghai Airlines (SAL) catapults CEA ahead of Air China as China's second largest carrier by fleet size, behind China Southern Airlines. During a January 12 meeting, CEA representatives told CongenOffs that CEA's market share in Shanghai will rise to around 46 percent by passenger volume. With 70-75 million visitors predicted to attend Shanghai's six-month long 2010 World Expo, CEA expects 2010 will be a profitable year with revenues rising by 20 percent. CEA anticipates 10-15 million Expo visitors will travel to Shanghai by plane, 3-8 million of whom CEA hopes will fill its flights. Following three years of massive losses from 2006-08 due to rising fuel prices, the global economic downturn and bungled fuel hedging contracts, CEA announced in early January that it anticipates 2009 will ultimately prove to have been a profitable year, albeit still having required a capital injection of RMB 14 billion (approximately USD 2 billion) from the Ministry of Finance. CEA's revenue is split 70/30 between its domestic and international routes, and the ultimate goal is to achieve a ratio of 50/50, according to the CEA representatives.

¶4. (SBU) In response to a question regarding competition from several high-speed rail routes coming into service in the near future, the CEA representatives admitted rail would probably pose a challenge, especially for travel between 800-1500 km in

length where travel times would be comparably close to air options. On routes longer than 1,500 km, air transport would likely provide the more attractive option in spite of high-speed rail availability, they commented. In addition, while security check-in procedures for high-speed rail remained relatively less burdensome in comparison with that at airports, the CEA representatives highlighted a recent incident whereby a smoking passenger on the Wuhan-Guangzhou line triggered a prolonged delay as potentially foreshadowing more onerous security procedures for rail travelers. Should security check-in procedures at train stations become more time consuming, they reasoned, air travel would remain an appealing option.

Shanghai Accepts Merger...with Conditions

¶5. (SBU) Prior to the merger, SAL was a locally administered state-owned enterprise (SOE) of the Shanghai Municipal Government. (Note: China Eastern Air Holding Company, CEA's parent company, is also largely state-owned but by China's central government. The Communist Party's Central Organization Department approves CEA's chairman although the State Council's State-owned Assets Supervision and Administration Commission selects the senior vice presidents. End Note.) The CEA representatives claimed that Shanghai municipal authorities were supportive of the merger because the consolidation would enhance Shanghai's goal of becoming an international shipping and transportation center. Furthermore, CEA's resulting market share for the lucrative Shanghai market would approach 50 percent. Retaining the Shanghai Airlines brand, the CEA officials explained, would also prevent additional entrants to the Shanghai market due to a Civil Aviation Administration of China (CAAC) regulation restricting the number of airline branch offices per airport.

¶6. (SBU) SAL Senior Vice President Ms. Shao Xiaoyun told the

Deputy Principal Officer February 4 that, while SAL would become an independent, fully owned subsidiary of CEA, SAL's cargo operations, marketing, ground maintenance, and unspecified other departments would be consolidated with CEA. Furthermore, since both airlines previously were registered in Shanghai, the Shanghai Municipal Government would experience no significant change in tax revenue as a result of the merger. (Note: Enterprise income tax revenues accrue to the jurisdiction where the firm is registered. End Note.)

¶7. (SBU) When asked about management personnel changes, Shao stated that SAL's Acting President and Communist Party Secretary Mr. Gu Jiadan had been appointed as a vice president of China Eastern Air Holding Company. Shao claimed that no lay-offs would result from the merger although some personnel "adjustments" could not be ruled out. The Shanghai Airlines brand would remain, she noted, while CEA representatives told us the brand would be maintained for a minimum of three years post-merger. Shao was similarly hopeful that 2010 would be a profitable year for SAL, stating that the Central Government's State-owned Assets Supervision and Administration Commission (SASAC) issued a decree prohibiting SOEs from entering into any derivative trading, to include fuel hedging contracts.

Oneworld in CEA's Future?

¶8. (SBU) Both CEA and SAL representatives demurred when asked about future international airline alliances. SAL's Shao said that once CEA decides which alliance it will join, if it is not the Star Alliance, then SAL's Star Alliance partnership would be canceled. In the interim, however, SAL's Star Alliance membership would continue. The CEA representatives pointed out that given Air China's membership in Star Alliance and China Southern's Skyteam partnership, CEA's options were more than likely limited to Oneworld, the third of the largest global

airline alliances. Media reports indicate that CEA will make an announcement mid-February concerning which global alliance it will join.

Outstanding Boeing Orders for CEA to Decide

¶9. (SBU) When asked about the nine Boeing 787 Dreamliner aircraft that SAL had on order, Shao noted that CEA itself had fifteen on order for a total of 24 between the two airlines. CEA plans for SAL to focus on shorter, regional routes while CEA continues its expansion into longer, international routes, Shao explained. Thus, ultimate disposition of the Boeing orders would be for CEA to decide. (Note: China Eastern announced in late December 2009 its intention to purchase 16 Airbus A330 aircraft for delivery between 2011-14, a deal worth USD 2.6 billion. End Note.)

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Taking on Shanghai's Airline Means Taking on Shanghai
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¶10. (SBU) Comment: On its face, China Eastern's acquisition of Shanghai Airlines looks appealing for both sides since both stand to gain from larger market share of one of China's most lucrative aviation markets. Nevertheless, despite the assurances received from China Eastern regarding continued branding and employment, the Shanghai Municipal Government, given Shanghai Air's close ties to local leadership, will surely miss the ability to dole out patronage in the form of attractive senior management positions. (Shanghai Executive Vice Mayor Yang Xiong is a former president and chairman of SAL.) More than half a year in the making, the deal has received widespread media attention with speculation focused on the inherent bureaucratic and political difficulties associated with consolidating a centrally administered SOE and a firm controlled by a (powerful) local government. End Comment.
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